January 31, 2000

Office of Information and Regulatory Affairs
Office of Management and Budget
Attn: Desk Officer for the Interior Department
(OMB Control Number 1010-NEW)
725 17th Street, N.W.
Washington, D.C. 20503

Re: Minerals Management Service--Proposed Supplementary Rule, Establishing Oil Value for Royalty Due on Federal Leases

Dear Sir or Madam:

On behalf of Chevron Pipe Line Company ("CPL"), enclosed are CPL's Second Supplemental Comments in above-referenced rulemaking.

As stated in the enclosed comments, CPL believes that the Minerals Management Service has not accurately estimated the burden associated with this rulemaking.

Please call me if you have any questions regarding these comments.

Sincerely,

Ruth A. Bosek
Counsel for Chevron Pipe Line Company

cc: Minerals Management Service

UNITED STATES OF AMERICA
BEFORE THE
DEPARTMENT OF THE INTERIOR
MINERALS MANAGEMENT SERVICE

Establishing Oil Value For Royalty	**)**	
Due on Federal Leases; Further	**)**	**64 F.R. 73820**
Supplementary Proposed Rule	**)**	

SECOND SUPPLEMENTAL COMMENTS OF
CHEVRON PIPE LINE COMPANY

Chevron Pipe Line Company ("CPL") hereby submits its Comments in response to the Further Supplementary Proposed Rule published by the Minerals Management Service ("MMS") on December 30, 1999, 64 F.R 73820 ("December 1999 Proposed Rule"). CPL submits that comments made by MMS in the December 1999 Proposed Rule demonstrate that the rulemaking process, as it applies to eliminating use of tariff rates as transportation allowances, is fatally tainted. CPL further submits that these and other comments made by MMS demonstrate that it does not fully comprehend ratemaking in general or the Federal Energy Regulatory Commission's ("FERC") regulation of oil pipelines in particular. Finally, the allowable rate of return should be at least two times the Standard and Poor's industrial bond yield index.

I. CORRESPONDENCE AND COMMUNICATIONS

All correspondence and communications regarding these Comments should be directed to:

Ruth A. Bosek
Bosek Law Firm
1090 Vermont Ave., N.W., Suite 800
Washington, D.C. 20005
Telephone: 202/326-5256
Facsimile: 202/289-7624
Email: rbosek@boseklaw.com

II. COMMENTS

A. MMS' FAILURE TO DISCLOSE ITS TRUE RATIONALE FOR REMOVING THE TARIFF OPTION HAS DENIED ENTITIES THE ABILITY TO COMMENT MEANINGFULLY AND FATALLY FLAWED THIS RULEMAKING.

The December 1999 Proposal is the latest in a series of proposed and supplementary proposed rules in a rulemaking initiated by the MMS on January 24, 1997. In the Notice of Proposed Rulemaking ("NOPR") published that day, MMS proposed eliminating the use of tariffs filed with the FERC or State regulatory agencies as bases for transportation allowances for oil transported under non-arms' length contracts. The only rationale given at that time was that MMS believed that the

> use of actual costs is fair to lessees and that the existing requirement to use a FERC approved tariff is no longer a viable alternative since FERC ruled that it lacks jurisdiction with respect to oil pipelines located wholly on the Outer Continental Shelf.

62 F.R. at 3746.

MMS subsequently published three other supplementary proposed rules before the December 1999 Proposed Rule.[1] MMS did not comment on its rationale for eliminating the tariff option in any of these supplementary proposed rules. Then, in the December 1999 Proposed Rule--issued nearly three years after the initial NOPR--MMS made two assertions for the first time. First, it stated that it was removing the tariff option because "[w]e continue to believe that FERC tariffs often exceed the transporter's actual costs." 64 F.R. at 73835. Second, it said that the majority of Federal royalty transportation occurs on Outer Continental Shelf ("OCS") pipelines over which FERC has disclaimed jurisdiction. Id. MMS' failure to disclose these critical facets of its reasoning when it proposed removing the tariff option, so that affected parties would have an effective opportunity to comment, taints that aspect of the rulemaking that would remove the tariff option.

"The rulemaking process requires an agency 'to fairly apprise interested parties of all significant subjects and issues involved,' [citation omitted] so that they can participate in the process." Fertilizer Institute v. Browner, 163 F.3d 774, 778 (3rd Cir. 1998). See also, Grand Canyon Air Tour Coalition v. Federal Aviation Administration, 154 F.3d 455, 468 (D.C. Cir. 1998) ("An agency is required to provide a meaningful opportunity for comments…."). MMS has deprived affected entities of the knowledge that MMS believes (1) that FERC tariff rates exceed "actual costs" and (2) that FERC does not have Interstate Commerce Act ("ICA") jurisdiction over the majority of pipelines providing Federal royalty transportation. MMS has also deprived parties knowledge of as the bases for those beliefs. In so doing, MMS has not informed commenters of all significant issues involved nor has it provided a meaningful opportunity for comments. The limited notice provided in the December 1999 Proposal, coupled with the extremely short comment period, does not cure MMS' failure.

B. MMS' BELIEF THAT TARIFF RATES EXCEED ACTUAL COSTS IS SUBJECTIVE AND UNSUBSTANTIATED.

The December 1999 Proposal was the first time that MMS revealed, in any of the formal notices issued in this rulemaking, that its determination to eliminate the tariff option was based on its continued opinion that FERC tariff rates exceed what MMS

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[1] These were published on July 3, 1997, 62 F.R. 36030; February 6, 1998, 63 F.R. 6113; and July 16, 1998, 63 F.R. 38355.

believes to be actual costs. MMS did not provide any basis for its newly expressed, but apparently long-held, opinion that tariff rates exceed actual costs. The only reference to that belief prior to the December 1999 Proposal that CPL has been able to locate appears in MMS' "Summary of Industry Recommended Improvements to MMS Oil Valuation Proposed Regulations and MMS Responses Discussed at July 22, 1998, Senate Meeting," as amended on July 29, 1998 ("MMS July 1998 Response"). In that document, MMS stated that its audits have found FERC tariffs significantly exceed a pipeline's actual costs of transportation. MMS July 1998 Response at 5. Even then, however, MMS offered no details to support its statement, such as the number of audits conducted, over what period of years, how it calculated costs, by what level it calculated tariffs to exceed actual costs, etc. MMS' unsupported statement demonstrates the agency's misunderstanding of ratemaking and of what a pipeline's "actual costs" are.

CPL presumes that MMS' conclusion that tariff rates exceed "actual costs" is based upon a comparison of particular pipelines' tariff rates with their costs as computed by MMS in accordance with its current regulations found at 30 C.F.R. § 206.105(b). The validity of MMS' conclusion is, in turn, wholly dependent upon the assumption that the MMS' method of calculating pipeline costs is the only valid method of computing a pipeline's actual costs. That is assuredly not the case.

It is an axiom that an entity whose rates are regulated, such as oil pipelines, are entitled to recover their reasonable and prudent costs and a reasonable return on their investment. Federal and State agencies with the authority to regulate such entities' rates have spent decades developing methodologies that accurately reflect those costs, determine what a reasonable return is and allocate the charges among the regulated company's various customers. MMS is an agency with no experience or expertise in ratemaking and the method it has set out in 30 C.F.R. § 206.105(b) does not necessarily comport with established ratemaking methodologies. It cannot be said, therefore, that MMS' method of calculating "actual costs" is the only valid such method, or even a valid method. Under such circumstances, MMS' conclusion that tariff rates exceed "actual costs" is unsubstantiated and unsustainable.

One facet of MMS' current rule that acts to decrease MMS-computed costs below those justified by traditional ratemaking methodologies is the level of the allowed return. MMS currently limits the rate of return to the "industrial rate associated with Standard and Poor's BBB rating." 30 C.F.R. § 206.105(b)(2)(v). Under traditional ratemaking, the rate of return is generally developed for a specific company and is based upon the characteristics of that company (including its debt/equity ratio), its particular industry, and an assessment of risk. Using the Standard and Poor's BBB rating not only eliminates both the company-specific and risk assessments, but sets the rate of return at a very low level, which in turn would significantly lower the "actual costs" of the pipeline.

This can be very clearly seen by comparing the average Standard and Poor's BBB yield for the past several years with the rate of return on equity approved by FERC for setting the rates of natural gas pipelines operating on the OCS.[2] The average Standard and Poor's BBB yield for bonds with one year maturities was 6.0561% in 1996,[3] 6.0208% in 1997, 5.8681% in 1998 and 6.3879% in 1999. By contrast, in 1996, FERC

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[2] Natural gas and oil pipelines companies are not necessarily identical in their characteristics but natural gas pipelines have been used as proxies for oil pipelines in assessing the proper rate of return.

[3] Standard and Poor's changed the methodology of calculating these rates in February 1996 and 6.0561% is the average from February through December 1996.

approved a 13.25% return on equity for an OCS gas pipeline,[4] more than twice the Standard and Poor's yield. In 1997 FERC approved a 13.25% return on equity for two OCS pipelines[5] and a 14% return on equity for a third OCS pipeline,[6] again more than twice the Standard and Poor's yield. In 1999, FERC approved returns on equity for non-OCS pipelines, which are generally considered to have lower risk than OCS pipelines, of 12.38% and 14%,[7] again generally twice the average Standard and Poor's yield.

Rate of return has an extremely significant impact on a tariff rate. MMS, by limiting the allowable rate of return to about half of what has been deemed reasonable for pipelines, is virtually guaranteeing that tariff rates will always exceed what MMS considers to be the actual costs.

The above discussion is not a comprehensive treatment of how MMS' current computation of "actual costs" differs from traditional ratemaking or FERC oil pipeline ratemaking, but only highlights one of the most significant variations. This and other variations[8] mean that MMS' conclusion that tariff rates exceed actual costs is unsubstantiated. MMS should not remove the tariff option based upon such an unsubstantiated conclusion. Instead, MMS should provide additional formal notice of the

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4 Shell Gas Pipeline Co., 76 FERC ¶ 61,126 (1996).

5 Garden Banks Gas Pipeline, LLC, 78 FERC ¶ 61,066, 61,241 (1997) and Destin Pipeline Company, L.L.C., 79 FERC 61,395, 62,707 (1997).

6 Discovery Producers Services LLC, 78 FERC ¶ 61,194, 61,842 (1997).

7 Iroquois Gas Transmission System, L.P., 86 FERC ¶ 61,261, 61,950, 61,954 (1999) (for proposed rates filed in late 1996) and Maritimes & Northeast Pipelines, L.L.C., 87 FERC ¶ 61,061, 61,258 (1999) (for proposed rates filed in 1999) and Questar Southern Trails, 89 FERC ¶ 61,050, 61,148 (1999) (for proposed rates filed in 1999).

8 For example, MMS does not allow inclusion of Federal or State income taxes in the cost calculation, 30 C.F.R. § 206.105(B)(2)(iii), while such costs are permitted in traditional ratemaking.

detailed basis of this conclusion and allow parties sufficient time to comment upon the support offered by MMS for this conclusion.

C. MMS' OTHER STATED REASON FOR REMOVING THE TARIFF OPTION, LACK OF FERC JURISDICTION, IS SIMILARLY FLAWED.

In its two sets of prior comments in this Rulemaking, CPL has addressed in detail the issue of FERC jurisdiction over OCS pipelines. CPL explained that it does not agree with the FERC's determination that it does not have ICA jurisdiction over certain OCS pipelines. CPL also explained that, even accepting FERC's view of its jurisdiction, MMS has incorrectly expanded the FERC holdings. MMS appears to believe that FERC has disclaimed ICA jurisdiction over all OCS pipelines, when in fact FERC has determined that it does have jurisdiction over certain OCS pipelines.

MMS has provided an extremely limited and insufficient response to CPL's comments. It stated in the December 1999 Proposal that it cannot presume FERC's reasoning pertaining to its ICA jurisdiction to be flawed. It went on to state that "even if FERC's non-jurisdictional determinations are exclusive to offshore pipelines, those pipelines involve the great majority of transportation allowance deductions for Federal royalty purposes." 64 F.R. at 73835.[9]

It is impossible to determine whether MMS' reference to the "offshore pipelines" that involve the majority of Federal royalty transportation means only those pipelines which do not exit the OCS or includes those pipelines that begin on the OCS and transport crude through the seaward boundaries of a coastal State. If it is the latter, then

[9] MMS' rationale for removing the tariff option based upon alleged lack of FERC jurisdiction over OCS pipelines provides no justification for removing that option for non-OCS pipelines or pipelines subject to rate regulation by State agencies.

MMS is incorrectly including OCS pipelines over which FERC has held that it does have ICA jurisdiction, if those pipelines transport oil that moves from the first state to a second without a break in transportation. Ultramar, Inc. v. Gaviota Terminal Co., 80 FERC ¶ 61,201, 61,810 (1997). CPL has pointed this out in its prior comments but MMS appears to have ignored that distinction.

Under FERC's view, any crude that moves from the OCS through the seaward boundaries of a State is potentially subject to its ICA jurisdiction and any such crude that moves from the first State to a second State without a break in transportation is in fact subject to FERC's ICA regulatory jurisdiction from the beginning of the movement on the OCS. A pipeline accepting crude for transportation from the OCS through the seaward boundary of a state often does not know whether that crude is going to be transported to a second state without a break in transportation. Some crude moving from the OCS to onshore may stay in the first state and other crude moving between the same OCS origin and onshore destination under the same rate may continue in transportation to a second state. Thus, a prudent pipeline transporting from the OCS will maintain FERC tariffs with the rates for those movements.

CPL cannot comment on whether most rates on OCS pipelines are potentially subject to FERC ICA jurisdiction under the test FERC has enunciated, but can only speak for itself. CPL has approximately 27 tariffs on file with FERC that involve movements originating on the OCS. These tariffs have 83 separate rates and over 70% percent of those rates are for movements from the OCS through the seaward boundaries of a State. Therefore, in order to insure that it is in compliance with the law, CPL must, at a minimum, maintain tariffs at the FERC with the rates for those movements. Otherwise, if FERC found that specific shipments moving under these rates were subject to the ICA, it could impose penalties if CPL does not have rates for such movements on file with it.[10] In order for CPL to maintain these rates in tariffs filed at FERC, it must comply with all FERC's regulations pertaining to oil pipeline rates. Therefore, compliance with FERC's ICA regulatory requirements is mandatory for the great majority of CPL's OCS rates

FERC's ICA regulatory scheme imposes limitations on pipeline rates even if FERC does not perform a cost-of-service analysis for each individual rate. An oil pipeline cannot increase filed rates at will. It can increase existing filed rates in only one of four manners. First, it may increase rates in accordance with the index that became effective in 1995, if the index for the year is positive. Under the index, oil pipeline rates have been allowed to increase twice in the last five years and were required to be decreased in the other three years (the net result is that rates changed according to the index are at about the same level they were in 1995).[11] Second, the pipeline can obtain the consent of all the current shippers using the rate. Third, the pipeline could file a cost-of-service justification for the new rate. Fourth, the pipeline could attempt to secure from FERC a determination that it lacks market power. Once a pipeline obtains a lack of market power determination for certain markets, it can change rates for those markets without regard to the index. No pipeline has yet sought a lack of market power determination for rates for transportation on or from the OCS.

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[10] This is not an academic concern. FERC imposed a $4 million penalty on CPL's affiliate for failing to have filed tariff rates on the South Timbalier System, which originates on the OCS. South Timbalier Pipeline System, 29 FERC 61,345 (1984). CPL now owns and operates the South Timbalier System.

[11] There are some exceptions to the requirement to decrease rates. If the existing rate is below the new index ceiling or if the index would reduce a rate below its grandfathered level, it does not have to be decreased.

Under FERC's regulatory scheme, then, a pipeline transporting from the OCS can increase its filed rates only in accordance with the index when it is positive, with the consent of all its shippers or upon a cost-of-service showing. It cannot, as suggested by MMS at the July 1998 meeting, simply raise the tariff rate at will.[12] This means that any rates filed at FERC are subject to ICA regulation. Any contention that a pipeline can avoid that ICA regulation simply by not filing tariff rates fails to take into account the pipeline's potential liability if it is found to have violated the ICA by providing jurisdictional transportation without filed tariff rates. MMS cannot reasonably expect pipelines to place themselves at such risk of violating the law.

D. MMS IS IGNORING THE DISTINCTIONS BETWEEN PRODUCERS AND THEIR REGULATED PIPELINE AFFILIATES AND HAS WRONGLY ESTIMATED THE BURDEN OF COMPLYING WITH THE PROPOSED RULE.

Chevron Production, the CPL affiliate holding OCS leases, cannot supply MMS with the pipeline cost data necessary to calculate "actual costs" under either the current or proposed regulations. CPL is the transporter that has that information. In the December 1999 Proposal, MMS stated that where producing and transporting affiliates are involved, "the entity claiming the allowance should be able to acquire any needed records from its affiliate." 64 F.R. at 73835. This statement completely ignores the issue CPL raised in its first set of comments, that Section 15(13) of the ICA places limitations on the information that a pipeline may disclose under penalty of criminal violation.

[12] Notes of July 22, 1998 Meeting (published on the MMS website) at 8-9. The comment was made in response to a producer representative noting the disparate treatment of two producers on the same reservoir, which could result in a competitive disadvantage for one producer. The producer transporting through a regulated but non-affiliated pipeline can deduct the full tariff rate but another transporting through a regulated but affiliated pipeline cannot. An MMS representative disagreed that there was disparate…

Section 15(13) of the ICA prohibits a pipeline from disclosing "any information concerning the nature, kind, quantity, destination, consignee or routing" of any shipper's property except under certain specified circumstances. Chevron Production is not the only shipper on CPL's pipelines. In order for costs attributable to only one shipper are to be calculated, cost allocations based upon all shippers' movements must be performed. CPL cannot provide the information to perform those allocations to its affiliate, but must perform the cost calculations itself.

This is going to impose a substantial burden on CPL and other pipelines with affiliated shippers. In its initial comments, CPL explained that the MMS regulations do not track the manner in which CPL is required to maintain records under the Uniform System of Accounts for Oil Pipelines established by the FERC nor do they calculate a pipeline's costs in the same manner. Complying with MMS' regulations in order to calculate Chevron Production's transportation allowances would require CPL to generate new and different financial analyses and records than it currently keeps in the ordinary course of business.

MMS did not address the burden it would be imposing on affiliated pipelines in the December 1999 Proposal. It only acknowledged that removing the tariff option might increase audit costs "somewhat." 64 F.R. at 73835. This downplaying of potential audit costs is at odds with MMS' acknowledgment, in its Paperwork Reduction Act submission to the Office of Management and Budget ("OMB"), that

> [w]hen a company is audited, it incurs significant costs. It may be required to gather records, provide documents, and in some cases provide space and facility resources.

…treatment, but then stated that the pipeline owner not subject to regulation could raise its tariff (presumably for the non-affiliated shipper) to level the playing field. This ignores the fact that if a tariff rate is filed with FERC, it cannot simply be raised at will.

Further Supplementary Proposed Rule—Valuation of Federal Royalty Oil, RIN 1010-AC09, Threshold Analysis (December 1999) at 21.

Moreover, MMS' assessment of the information collection and additional costs associated with the proposed rules is incomplete. In the December 1999 Proposal, MMS stated that, for all of the information collection estimates presented, it estimated that there would be 45 respondents. It then identified these 45 respondents as lessees of Federal leases. 64 F.R. at 73839. It is apparent, therefore, that MMS did not even consider the information collection associated with the lessees' affiliated pipelines. Additionally, in the section addressing "Requirements Related to Special Requests Due to Unique Circumstances," 64 F.R. at 73840-73841, the only burden estimates MMS provided associated with the removal of the tariff option were for proposing cost allocations when transporting more than one product and for electing the transportation cost and depreciation methods. There is no estimate of the information collection requirements for assembling the data necessary for computing the transportation allowance, computing the allowance or providing the allowance justification to MMS.

In its initial comments, CPL estimated that compiling the cost data in accordance with the MMS regulations and allocating those costs to determine the transportation allowance for Chevron Production would require an initial effort of five person weeks. This initial effort would be required for each of the past years for which Chevron Production is not allowed to use the tariff rate for its transportation. CPL understands that MMS has denied Chevron Production the use of CPL's tariff rates for each year beginning in 1993. This will impose a minimum burden of 35 person weeks on CPL and that minimum burden will increase to extent MMS questions any aspect of the transportation allowance.

E. THE ALLOWED RATE OF RETURN SHOULD BE AT LEAST TWO TIMES THE STANDARD AND POOR'S BBB INDUSTRIAL BOND YIELD INDEX.

CPL has shown in the earlier discussion that the Standard and Poor's BBB industrial bond yield has generally been less than one half the rate of return authorized by FERC for OCS natural gas pipelines over the past several years and will not repeat that discussion here. Based upon that comparison, MMS should allow at least twice the bond yield as the rate of return.

MMS should also clarify what maturity bonds are to be used for the rate of return. Standard and Poor's publishes bond yield indexes for bonds with one, five, ten, fifteen and twenty years' maturities. CPL used the indexes for bonds with one year's maturity. The proposed regulations require the use of the average rate for the first month of the reporting period and CPL assumed that the reporting period would be annual.

III. CONCLUSION

CPL continues to oppose the removal of the tariff option as a method of calculating the transportation allowance. MMS' determination to eliminate the tariff option appears to be based primarily upon two conclusions, of which MMS did not provide notice until this latest proposed supplementary rule, nearly three years into the rulemaking. MMS failed to substantiate its conclusions. Notice of them has come just prior to the time MMS expects to issue the new regulations and without sufficient time for parties to prepare substantive comments on the issue.

MMS should reopen the comment period and provide the parties with the detailed bases for the two conclusions (1) that tariff rates exceed "actual costs" and (2) that the majority of Federal royalty transportation occurs on OCS pipelines for which FERC has disclaimed jurisdiction. It should also assess the burden removal of the tariff option will impose on both lessees and affiliated pipelines. It should then allow a reasonable comment period of no less than 60 days. Otherwise, MMS has failed its obligation to allow meaningful participation in this Rulemaking.

Respectfully submitted,

Ruth A. Bosek
Bosek Law Firm
1090 Vermont Ave., N.W., Suite 800
Washington, D.C. 20005
202/326-5256

Counsel for Chevron Pipe Line Company

Dated: January 31, 2000